199939046

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date:

JUL 06 1999

Contact Person:

ID Number:

Telephone Number:

U.I.L. Nos.

4941.04-00
4943.04-03
4945.04-00

Employer Identification Number:

LEGEND

A =
J =
K =
L =
M =
N =
O =
P =
Q =
R =
S =
T =
U =
V =
W =
X =
Y =
Z =

Dear Applicant:

This letter responds to L's request dated January 12, 1999 for a ruling whether its participation in an investment partnership will result in excise tax under sections 4941, 4943, or 4945 of the Internal Revenue Code.

Facts:

L, M, N, O, P, Q, R, S, T, U, V, W, X, Y, and Z are 15 private foundations described in sections 501(c)(3) and 509(a) of the Code. Each foundation is a disqualified person with respect to the others under section 4946(a)(1)(H).

Investment management is provided to the foundations by J, a family-owned company controlled by A. J provides its services to L for a fee and to the other foundations free of charge.

233

The 15 foundations plan to form K, a general partnership, to make certain investments together. The 15 foundations will be the only partners, and the partnership agreement will prohibit the admission of partners that are not private foundations. L will serve as the managing general partner. J will provide investment management and administrative services to K at no charge.

Upon formation of K, each foundation will make a maximum dollar commitment to K after analysis of its particular investment portfolio and projected cash flow. K's capital calls will be funded by each foundation in proportion to (but not in excess of) its commitment as investments are made. Participation in distributions and allocation of profits and losses will likewise be in the ratio of the foundations' respective capital investments in K. Funding of capital calls will be mandatory upon the request of the managing general partner.

Each foundation will invest a relatively small percentage of its investment portfolio in the proposed partnerships; it is anticipated that each foundation's investment in and capital commitment to the partnerships will not exceed 20% of the value of its investment portfolio at the time that any partnership capital commitment is made. Each foundation's other investments will generally consist of cash and cash equivalents, U.S. government obligations, corporate debt securities, equity mutual funds, and publicly traded corporate stock.

It is contemplated that a new investment partnership may be formed each year. This arrangement will permit each foundation to review its particular investment portfolio and needs annually and to vary its investment commitment relative to the other foundations without complicating the administration of a single partnership.

The purpose of K (and the subsequent partnerships) is to enable each foundation to invest in equity interests in private businesses and private equity funds not otherwise available to them, and to achieve greater diversification in investments. The investments generally will be made in other ("lower-tier") limited partnerships (J will not manage the lower-tier partnerships), to which K will subscribe as a limited partner. With the possible exceptions of L and M, none of the foundations could participate individually in such investments due to requirements (for reasons of administrative convenience and securities laws) as to the maximum number and minimum financial size and dollar commitments of investors.

The partnership agreement prohibits K from:

1. making any investments that would cause any of the foundations to be subject to an excise tax under section 4944 of the Code;

2. directly engaging in an operating business; and

3. making any investment that would cause the combined interests of any Partner and all disqualified persons with respect to such Partner in any business enterprise to exceed the permitted holdings of the Partner under Code section 4943 and the regulations thereunder.

The other limited partnerships in which K (and subsequent partnerships) invest may be engaged in active trades or businesses. K's gross income from non-passive sources (e.g., income from partnerships engaged in an active trade or business) may exceed 5% in any given year. The

foundations will treat their proportionate shares of such income as unrelated business income and pay tax accordingly under section 512(c) of the Code.

In compliance with section 4941(d)(1)(A) of the Code, K will not buy property from, sell property to, exchange property with, or lease property to or from a disqualified person with respect to any of the foundation partners (other than as permitted under section 53.4941(a)-1(a)(1) of the regulations).

In compliance with section 4941(d)(1)(B) of the Code, K will not receive credit from, or extend credit to, a disqualified person with respect to any of the foundation partners.

In compliance with section 53.4941(d)-2(f)(1) of the regulations, K will not purchase or sell investments in an attempt to manipulate the price of the investments to the advantage of a disqualified person.

Rulings Requested:

Rulings are requested that the formation and operation of K will not:

(1) constitute an act of self-dealing under section 4941 of the Code;

(2) result in excess business holdings under section 4943; and

(3) constitute a taxable expenditure under section 4945.

Law:

Section 512(c)(1) of the Code provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in section 512(b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.

Section 513(c) of the Code provides that the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services.

Section 4941(a) of the Code imposes an excise tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1) of the Code defines self-dealing as including any direct or indirect--

(A) sale or exchange, or leasing, of property between a private foundation and a disqualified person;

(B) lending of money or other extension of credit between a private foundation and a disqualified person;

(C) furnishing of goods, services, or facilities between a private foundation and a disqualified person;

(D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;

(E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4941(d)(2)(C) of the Code provides that the furnishing of goods, services, or facilities by a disqualified person to a private foundation shall not be an act of self-dealing if the furnishing is without charge and if the goods, services, or facilities so furnished are used exclusively for purposes specified in section 501(c)(3).

Section 4941(d)(2)(E) of the Code provides generally that the payment of compensation by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation is not excessive.

Section 4943(a)(1) of the Code imposes an excise tax on a private foundation's excess business holdings in a business enterprise during any tax year.

Section 4943(c)(1) of the Code defines excess business holdings as a private foundation's holdings of interests in business enterprises in excess of permitted holdings.

Section 4943(c)(2)(A) of the Code generally defines the permitted holdings of a private foundation in an incorporated business enterprise as 20% of the voting stock, reduced by the percentage of voting stock owned by all disqualified persons. If all disqualified persons together own no more than 20% of the voting stock, nonvoting stock held by the foundation is also a permitted holding.

Section 4943(c)(2)(B) of the Code provides that where the foundation and all disqualified persons together own no more than 35% of the voting stock, and it is established to the Service's satisfaction that effective control of the corporation is in one or more non-disqualified persons, then the private foundation's holding is a permitted holding.

Section 4943(c)(2)(C) of the Code provides that a foundation is not treated as having excess business holdings in a corporation in which it (together with all other foundations described in section 4946(a)(1)(H)) owns no more than 2% of the voting stock and no more than 2% in value of all outstanding shares of all classes of stock.

Section 4943(c)(3) of the Code provides that the permitted holdings of a private foundation in a business enterprise that is not incorporated is determined under regulations consistent in principle with section 4943(c)(2), except that--

(A) in the case of a partnership or joint venture, "profits interest" is substituted for "voting stock," and "capital interest" is substituted for "nonvoting stock,"

(B) in the case of a proprietorship, there are no permitted holdings, and

(C) in any other case, "beneficial interest" is substituted for "voting stock."

Section 4943(d)(1) of the Code provides generally that in computing the holdings of a private foundation or a disqualified person in any business enterprise, any stock or other interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.

Section 4943(d)(3) of the Code provides that a "business enterprise" does not include--

(A) a functionally related business (as defined in section 4942(j)(4)), or

(B) a trade or business at least 95% of the gross income of which is derived from passive sources (including income described in section 512(b)(1), (2), (3), and (5), and income from the sale of goods if the seller does not manufacture, produce, physically receive or deliver, negotiate sales of, or maintain inventories in such goods).

Section 4945 imposes an excise tax on taxable expenditures by a private foundation.

Section 4945(d) defines a "taxable expenditure" as including any amount paid or incurred by a private foundation for any purpose other than one specified in section 170(c)(2)(B).

Section 4946(a)(1)(H) of the Code provides that for purposes of section 4943 only, a disqualified person with respect to a private foundation includes a private foundation

(i) which is effectively controlled (directly or indirectly) by the same person or persons who control the private foundation in question, or

(ii) substantially all of the contributions to which were made (directly or indirectly) by the same person or persons described in section 4946(a)(1)(A), (B), or (C), or members of their families (within the meaning of section 4941(d)), who made (directly or indirectly) substantially all of the contributions to the private foundation in question.

Section 1.513-1(b) of the Income Tax Regulations provides that the term "unrelated trade or business" has the same meaning it has in section 162 of the Code, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. Thus, the term "trade or business" in section 513 is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code.

In section 53.4941(d)-3(c)(2), Example (2) of the Foundations and Similar Excise Taxes Regulations, C, a manager of private foundation X, owns an investment counseling business. Acting in his capacity as an investment counselor, C manages X's investment portfolio for which he receives an amount which is determined to be not excessive. The payment of such compensation to C shall not constitute an act of self-dealing.

Section 53.4943-8(c)(1) of the regulations provides generally that any interest (whether or not in a separate entity) owned by a corporation that is actively engaged in a trade or business is not deemed constructively owned by its shareholders.

Section 53.4943-8(c)(2) of the regulations provides that for purposes of section 53.4943-8(c)(1)--

> (i) A corporation is not considered actively engaged in a trade or business if the corporation is not a business enterprise by reason of section 4943(d)(3)(A) or (B);
>
> (ii) In the case of a corporation which owns passive holdings and is actively engaged in a trade or business, such corporation is not considered actively engaged in a trade or business if the net assets used in such trade or business are insubstantial compared to passive holdings.

Section 53.4943-8(d) of the regulations provides that any interest in a business enterprise which is owned by a partnership shall be deemed to be constructively owned by the partners in such partnerships.

Section 53.4943-10(a)(1) of the regulations provides that except as provided in section 53.4943-10(b) or (c), the term "business enterprise" includes the active conduct of a trade or business, including any activity regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under section 513 of the Code.

Section 53.4943-10(a)(2) of the regulations provides that a bond or other evidence of indebtedness does not constitute a holding in a business enterprise unless such bond or evidence of indebtedness is otherwise determined to be an equitable interest in such enterprise. Similarly, a leasehold interest in real property does not constitute an interest in a business enterprise, even though rent payable under such lease is dependent, in whole or in part, upon the income or profits derived by another from such property, unless such leasehold interest constitutes an interest in the income or profits of an unrelated trade or business under section 513.

Section 53.4943-10(b) of the regulations provides that the term "business enterprise" does not include a functionally related business, and that business holdings do not include program-related investments.

Section 53.4943-10(c)(1) of the regulations provides that the term "business enterprise" does not include a trade or business at least 95% of the gross income of which is derived from passive sources; except that if in the taxable year in question less than 95% of the income of a trade or business is from passive sources, the foundation may, in applying this 95% test, substitute for the passive source gross income in such taxable year the average gross income from passive sources for the 10 taxable years immediately preceding the taxable year in question (or for such shorter period as the entity has been in existence). Thus, stock in a passive holding company is not to be considered a holding in a business enterprise even if the company is controlled by the foundation. Instead, the foundation is treated as owning its proportionate share of any interests in a business enterprise held by such company under section 4943(d)(1).

Section 53.4945-6(b)(1) of the regulations provides that expenditures to acquire investments entered into for the purpose of obtaining income or funds to be used in furtherance of purposes described in section 170(c)(2)(B) of the Code, and reasonable expenses with respect to such investments, ordinarily will not be treated as taxable expenditures under section 4945(d)(5).

Section 53.4945-6(b)(2) of the regulations provides that, conversely, any expenditures for unreasonable administrative expenses, including compensation, consultant fees, and other fees for services rendered, will ordinarily be taxable expenditures under section 4945(d)(5) of the Code unless the foundation can demonstrate that such expenses were paid or incurred in the good faith belief that they were reasonable and that the payment or incurrence of such expenses in such amounts was consistent with ordinary business care and prudence. The determination whether an expenditure is unreasonable shall depend upon the facts and circumstances of the particular case.

Section 53.4946-1(a)(8) of the regulations provides that for purposes of section 4941 of the Code only, an organization described in section 501(c)(3) (other than an organization described in section 509(a)(4)) is not a disqualified person.

In H.R. Rep. No. 413 (Part 1), 91st Cong., 1st Sess. 27 (1969), and S. Rep. No. 552, 91st Cong., 1st Sess. 38-39 (1969), The House Ways & Means Committee and Senate Finance Committee stated the following concerns underlying the enactment of section 4943 of the Code:

1. the increased use of foundations to maintain control of businesses, and a corresponding decrease in concern about producing income for charitable purposes

2. uncertainty in the law at what point business involvement or noncharitable purposes become sufficiently great to disqualify a foundation from exempt status, and the harshness of revocation of 501(c)(3) exemption as a penalty

3. diversion of most of the interest and attention of the foundation managers away from their charitable duties to the maintenance and improvement of the business

4. where the charitable ownership predominates, the running of a business in a way that unfairly competes with businesses whose owners must pay tax on the income derived from their businesses

In S. Rep. No. 552, 91st Cong., 1st Sess. 38-39 (1969), the Senate Finance Committee cited the following examples in the Treasury Department's 1965 study of private foundations where business rather than charitable purposes appeared to predominate in foundation activities:

> Example 1. The A foundation holds controlling interests in 26 separate corporations, 18 of which operate going businesses. One of the businesses is a large and aggressively competitive metropolitan newspaper, with assets reported at a book value of approximately $10,500,000 at the end of 1962 and with gross receipts of more than $17 million for that year. Another of the corporations operates the largest radio broadcasting station in the State. A third, sold to a national concern as of the beginning of 1965, carried on a life insurance business whose total assets had a reported book value of more than $20 million at the end of 1962. Among the other businesses controlled by the foundation are a lumber company, several banks, three large hotels, a garage, and a variety of office

buildings. Concentrated largely in one city, these properties present an economic empire of substantial power and influence.

Example 2. The B foundation controls 45 business corporations. Fifteen of the corporations are clothing manufacturers; seven conduct real estate businesses; six operate retail stores; one owns and manages a hotel; others carry on printing, hardware, and jewelry businesses.

Example 3. The C foundation has acquired the operating assets of 18 different businesses, including dairies, foundries, a lumber mill, and a window manufacturing establishment. At the present time it owns the properties of seven of these businesses. Its practice has been to lease its commercial assets by short-term arrangements under which its rent consists of a share of the profits of the leased enterprise. By means of frequent reports and inspections, it maintains close check upon its lessees' operations.

In S. Rep. No. 552, 91st Cong., 1st Sess. 41 (1969), the Senate Finance Committee stated the following regarding the meaning of "business holding" under section 4943 of the Code:

> The committee also provided that stock in a passive holding company is not to be considered a business holding, even if the holding company is controlled by the foundation. Instead, the foundation is to be treated as owning its proportionate share of the underlying assets of the holding company. The committee also made it clear that passive investments generally are not to be considered business holdings. For example, the holding of a bond issue is not a business holding, nor is the holding of stock of a company which itself derives income in the nature of a royalty to be treated as a business holding.

Rev. Rul. 78-144, 1978-1 C.B. 168, held that a 501(c)(3) organization's leasing of heavy machinery under long-term lease agreements requiring the lessee to provide insurance, pay the applicable taxes, and make and pay for most repairs, with the functions of securing leases and processing rental payments performed for the organization without compensation, was not excepted from the term "unrelated trade or business" by reason of the volunteer labor exception under section 513(a)(1) of the Code. Once the organization found a lessee and leased the property, the only remaining requirement generally was to receive, record, and deposit the rents. The work in connection with finding a lessee, negotiating a lease, and processing the rental payments was performed for the organization without compensation. The Service reasoned that the rental of personal property is a trade or business, and that the volunteer labor exception applies only where the performance of services is a material income-producing factor in carrying on the business, and there was no significant amount of labor regularly required or involved in the kind of business carried on by the organization.

Rationale:

Section 4941 Issues

For purposes of section 4941 of the Code, none of the 15 foundations is a disqualified person with respect to any other, under section 53.4946-1(a)(8) of the regulations. Therefore, K is not a disqualified person with respect to any of the foundations either.

The formation and operation of K will not involve a sale or exchange or an extension of credit between a private foundation and a disqualified person, and will not involve a transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

The formation and operation of K as set forth above will not involve the furnishing of goods, services, or facilities between a private foundation and a disqualified person, other than J's provision of services to K (and indirectly to the foundation partners). However, under section 4941(d)(2)(C) of the Code, this provision of services will not result in self-dealing, as J's services will be provided without charge. Moreover, J's services are investment management services, which are permissible personal services for which a foundation may pay reasonable compensation under section 4941(d)(2)(E) of the Code and section 53.4941(d)-3(c)(2), Example (2) of the regulations. For the same reasons, the formation and operation of K as set forth above will not involve the impermissible payment of compensation or expenses by a private foundation to a disqualified person.

Section 4943 Issues

The main question presented is whether K itself is a business enterprise for purposes of section 4943 of the Code. If not, then none of the foundations' holdings in K will result in an excess business holding, given the representation that K will not make any investment that would cause the interest of any foundation (together with the interests of all disqualified persons with respect to such foundation) in any business enterprise to exceed the permitted holdings of the foundation under section 4943, and assuming that none of the foundations or disqualified persons subsequently acquire an interest (directly or indirectly) in such business enterprise.

If K were a business enterprise, then L's investment in K, along with the investments of the other foundations, would be an excess business holding, since the combined profit interests of L and the other foundation disqualified persons in K would be in excess of 20%, and the 2% de minimis rule of section 4943(c)(2)(C) of the Code would not apply. K would not meet the business enterprise exception under section 4943(d)(3)(B) of the Code, since it is contemplated that less than 95% of K's income will be derived from the listed passive sources. J's volunteer services for K would not, in our view, serve to exclude K from the definition of an unrelated trade or business, since J's services would not appear to be a material income-producing factor, under the reasoning of Rev. Rul. 78-144.

The taxpayer argues that K is not a business enterprise in the first place and therefore does not need the exception set forth in section 4943(d)(3)(B), and cites rulings such as Rev. Rul. 75-223 and to the definition of "trade or business" in other sections of the Code. We do not necessarily agree with the taxpayer's view that K, as described, will not be engaged in a trade or business for purposes of section 513 of the Code. Moreover, a strict reading of section 53.4943-10(c)(1) of the regulations would limit the term "passive holding company" to organizations receiving at least 95% of their gross income from the passive sources listed exclusively in section 4943(d)(3) of the Code.

However, the term "business enterprise" for the purposes of section 4943 may not encompass certain partnerships that engage solely in investment activities. The taxpayer represents that K's activities will consist of investing in private businesses, mainly as a limited partner in other limited partnerships. Furthermore, the taxpayer represents that K will not manage the business of the lower tier partnerships. Because limited partnership interests may represent passive

investments (comparable to stock and securities), K, based on the specific facts represented in this case, will not be treated as a business enterprise under section 4943.

The policies underlying section 4943 support our conclusion. The legislative history of the Tax Reform Act of 1969, P.L. 91-172, made it clear that Congress only sought to prevent private foundations from engaging in active businesses. Specifically, the Senate Finance Committee stated "that stock in a passive holding company is not to be considered a business holding, even if the holding company is controlled by the foundation. Instead, the foundation is to be treated as owning its proportionate share of the underlying assets of the holding company. The committee also made it clear that passive investments generally are not to be considered business holdings." See S. Rep. No. 91-552, 91st Cong. 1st Sess., reprinted in 1969 U.S. Code Cong. Serv. 2027, 2068.

K will not engage directly in any sale of goods or performance of services, but will merely hold interests in other business enterprises. The purpose of K is not to maintain family control of a business. The operation of K may actually result in less business involvement or diversion of attention of foundation managers toward investment activities than would otherwise be the case, except perhaps for the managers of the managing partner, L.

A contrary conclusion in this case would prevent the taxpayer from indirectly investing in limited partnership interests, through K, even though it could invest in such interests directly. The taxpayer has represented that K would not acquire more than a 20 percent interest in any limited partnership. The taxpayer and disqualified persons are allowed to directly hold up to a 20 percent interest in a business enterprise without violating the excess business holdings provision of section 4943. The mere interposition of K should not produce a different result.

We think this is a situation that calls for the application of the constructive ownership rules. Under the constructive ownership rule of section 4943(d)(1), K will not hold an impermissible interest in any business enterprise that would result in an indirect excess business holding for any of its foundation partners. Given that the foundation partners could directly hold such interests in business enterprises, and that K is formed for valid business reasons, we believe that the foundations should be allowed to form and hold interests in K to achieve the same result indirectly.

We emphasize that our ruling in this case applies solely to the facts as described and solely for purposes of section 4943 of the Code and not section 513 or other Code sections. The foundation partners of K will pay unrelated business income tax on their unrelated business taxable income in accordance with section 512(c).

Section 4945 Issues

The formation and operation of K as set forth above will not result in any expenditures by any foundation partners for noncharitable purposes if K's expenditures, and administrative payments from L to K, are reasonable. See sections 53.4945-6(b)(1) and (2) of the regulations.

Rulings:

Accordingly, we rule that the formation and operation of K will not:

(1) constitute an act of self-dealing under section 4941 of the Code;

(2) result in excess business holdings under section 4943; and

(3) constitute a taxable expenditure under section 4945 (assuming that K's expenditures, and administrative payments from L to K, are reasonable).

Except as we have ruled above, we express no opinion as to the tax consequences of the transaction under the cited provisions of the Code or under any other provisions of the Code.

This ruling is directed only to L. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Because this letter could help resolve any future questions about the application of Chapter 42 of the Code to its activities, L should keep a copy of this ruling in its permanent records.

We are providing the Key District Director a copy of this ruling.

Sincerely yours,

(signed) Garland A. Carter

Garland A. Carter
Chief, Exempt Organizations
Technical Branch 2